In the

Supreme Court of the United States

October Term, 1965

No. 26

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE

QUESTION PRESENTED

Whether, as a matter of law, the unanticipated sale of depreciable property in the middle of its estimated "useful life" for an amount in excess of its depreciated basis at the beginning of the year of sale necessarily bars the deduction of depreciation on the property for the period of its use during the year of sale.

STATEMENT OF INTEREST OF AMICUS CURIAE

This brief is filed by the undersigned attorneys as friends of the Court, with the consent of the petitioner and the respondent. The undersigned attorneys represent the taxpayer in the almost identical case of *S & A Co. v. United States*, 218 F. Supp. 677 (D. Minn. 1963), *aff'd*, 338 F.2d 629 (8th Cir. 1964), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term). The undersigned attorneys also are concerned, in their capacity as members of the Bar, with the serious implications of the theories proposed by the respondent and accepted both by the Tax Court[1] and by a majority of the Court of Appeals[2] in this case, as these theories would (if accepted by this Court) overturn over 40 years of relevant precedents and adversely affect numerous other taxpayers.

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[1]The opinion of the Tax Court is not officially reported, but it is unofficially reported at 21 CCH Tax Ct. Mem. 1533 (1962), and is reprinted at pages 2 to 18, inclusive, of the Transcript of Record before the Court in this case.

[2]The opinion of the Court of Appeals is reported at 335 F.2d 15 (1964). The majority opinion is reprinted at pages 76 to 82, inclusive, of the Transcript of Record, and Judge Moore's opinion in dissent is reprinted at pages 82 to 90, inclusive.

SUMMARY OF ARGUMENT

The Tax Court and a majority of the Court of Appeals in this case accepted respondent's novel theory that, as a matter of law, the sale of a depreciable asset conclusively terminates its previously estimated "useful life", and the sale price received for the asset automatically supplants any previously estimated "salvage value" of the asset for purposes of computing depreciation on the asset in the year of sale, and, therefore, the unanticipated sale of a depreciable asset in the middle of its estimated "useful life" for an amount in excess of its depreciated basis at the beginning of the year of sale necessarily bars any deduction for depreciation of the asset for the period of its use in that year. The lower courts denied the deduction for depreciation despite the fact that the "useful life" and "salvage value" of the asset involved which were used by taxpayer in computing the claimed depreciation had originally been approved by the Internal Revenue Service, and the reasonableness and accuracy of the "useful life" and "salvage value" so approved have not been questioned in this proceeding. In accepting this theory, and concluding that petitioner was not entitled to any deduction for year-of-sale depreciation of an asset sold in 1957, the lower courts completely misunderstood fundamental principles of depreciation accounting which are embodied in the basic statutory provision and which have been recognized, enunciated, refined, and followed by this Court, misinterpreted two decisions of this Court and a decision of the Court of Appeals for the Sixth Circuit, misapplied the pertinent provisions of the Treasury Regulations, ignored the basic dichotomy in the tax law between depreciation of property during the period of its use and recognition of gain or loss on its disposition, which is reflected in over 40 years of judicial precedents and administrative rulings and practice, ignored clear indicia of Congressional intent as evidenced for more than 20 years, and, in general, gave their stamp of approval

to a novel theory which has been thoroughly discredited in the overwhelming majority of contemporary court decisions.

The Court of Appeals, viewing the purpose of depreciation for income tax purposes to be to account for "the diminution of the asset's value each year", applied a literal meaning to the term "depreciation" for tax purposes. However, any use or meaning of the term "depreciation" as the converse of "appreciation" is irrelevant in determining the income tax allowance for depreciation. This irrelevance is made abundantly clear in basic, well-established accounting principles of depreciation, which this Court has held to be the matrix of the income tax allowance for depreciation, and in the pertinent statutory provision, Section 167(a) of the Internal Revenue Code, which allows as a depreciation deduction "a reasonable allowance for the exhaustion, wear . . . tear . . . [and] obsolescence" "of property used in the trade or business", and in the depreciation formula first enunciated by this Court in *United States v. Ludey*, 274 U.S. 295 (1927). These authorities all recognize that the term "depreciation" for income tax purposes means the physical and functional deterioration of property with use and lapse of time, and that depreciation accounting is a process of cost *allocation*, not of asset valuation.

The depreciation formula of the *Ludey* case recognizes that, in computing depreciation for income tax purposes, the allocable sum is original cost of an asset less its estimated "salvage value" and that the rate of allocation is determined by the asset's estimated "useful life". This Court, in *Massey Motors, Inc. v. United States* (decided with *Commissioner v. Evans*), 364 U.S. 92 (1960), and in *Hertz Corp. v. United States*, 364 U.S. 122 (1960), refined that formula, entirely consistent with well-established accounting authorities, by holding that "useful life" is the period, determined at the time of acquisition, for which the taxpayer *reasonably expects* the property to be useful in the business, and that

"salvage value", also determined at the time of acquisition, is the amount which the taxpayer *anticipates* the asset will be worth at the end of that "useful life". The Tax Court in this case erroneously assumed that this Court in *Massey* and *Hertz* had discarded the "old, well-established rules relating to depreciation allowances." In fact, those cases merely restated the principles outlined above and held that the *original* estimates of "useful life" and "salvage value" must take into account the taxpayer's established practices in disposing of assets of the type involved prior to the expiration of their normal physical life.

The decision of the Sixth Circuit in *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958), simply applied these well-settled principles to the peculiar facts involved in that case, *viz.*, a sale at or near the end of redetermined "useful life", and in no way supports the decisions of the lower courts in this case. The Tax Court in this case erroneously believed that *Cohn* also had discarded the "old, well-established rules", and a majority of the Court of Appeals concluded in error that respondent's new theory was "suggested by" the decision in *Cohn*.

The Treasury Regulations simply mirror the depreciation formula developed in accordance with well-established accounting principles and enunciated by this Court in *Ludey* and later refined and followed by this Court in *Massey* and *Hertz*, and also make it clear that, once properly estimated at the time of acquisition, "useful life" may not later be redetermined unless there is a "clear and convincing basis for" the change, and "salvage value" may not later be redetermined "merely because of changes in price levels," but may be redetermined only in connection with a redetermination of "useful life" and at no other time.

The dichotomy in the tax law between depreciation deductions while property is used in the trade or business and

computing and recognizing gain on the subsequent disposition of the asset is expressly recognized in respondent's Treasury Regulations. For over 40 years, from 1920 until the trial of this case in the Tax Court, respondent's long-standing practice of allowing depreciation in the year of sale of depreciable assets at a profit was fully reflected in his published rulings, practice, and acquiescence and in long-standing judicial precedents approving respondent's practice, including this Court's decisions in *Eldorado Coal & Mining Co. v. Mager,* 255 U.S. 522 (1921), and in *United States v. Ludey, supra,* and numerous other decisions of many lower courts including the Second Circuit's decisions in *Beckridge Corp. v. United States,* 129 F.2d 318 (2d Cir. 1942), and in *Kittredge v. Commissioner,* 88 F.2d 632 (2d Cir. 1937). All of these judicial and administrative precedents are completely consistent with well-established accounting principles in flatly contradicting respondent's present theory that a sale at a gain of a depreciable asset bars a deduction for depreciation in the year of sale and plainly indicate that such depreciation in fact is allowable.

Since 1918, Congress has repeatedly reenacted the basic statutory provision relating to the allowance for depreciation without relevant change. Moreover, from 1942 to 1962, Congress first granted, then expanded capital gains treatment to gains realized on the sale of depreciable assets, in spite of persistent warnings from the Treasury Department that this favorable treatment resulted in so-called "abuses." During that period, Congress considered and uniformly rejected proposed legislation designed to eliminate or to reduce these "abuses". Not until 1962, however, did Congress act upon any of these recommendations, and in 1962 and again in 1964 Congress approached the problem, prospectively, solely in terms of the nature of the gain recognized and *not* through a change in the long-standing statutory scheme pertaining to

depreciation deductions. By its reenactment of the depreciation provision in the light of an established administrative and judicial interpretation, Congress is presumed to have approved and adopted that interpretation.

These well-established principles of depreciation accounting, which were ignored by the lower courts in this case, have been applied in the overwhelming weight of contemporary court decisions in which respondent's new theory has been flatly rejected. The most carefully considered and thorough of these decisions is found in the opinion of Judge Blackmun in the case of *United States v. S & A Co.*, 338 F.2d 629 (8th Cir. 1964), *affirming* 218 F. Supp. 677 (D. Minn. 1963), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term). In the *S & A Co.* case, the Court of Appeals for the Eighth Circuit analyzed the applicable principles and reached conclusions identical in almost every respect with those urged in this brief. While the court considered all of the relevant arguments, its key comment is found in this statement:

> . . . There is no absolute identity of salvage value with sales price. The one is not necessarily equivalent to the other. Neither the statute nor the regulations equate them or make an exception out of the sale year. The emphasis, as has been noted, is, instead, on the estimate of salvage value, on such estimate at acquisition, on redetermination as the exception, on the distinct possibility of gain or loss on disposition, and on divorcement of salvage value from price level fluctuations.[3]

The decision of a majority of the Court of Appeals in this case, in parting company with all recognized principles of depreciation accounting as developed and followed in a long line of judicial and administrative precedents and accounting authorities and as evidenced in over 20 years of clear indicia of Congressional intent, is erroneous and should be reversed.

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[3] 338 F.2d at 640.

ARGUMENT

PETITIONER IS ENTITLED TO THE DEDUCTION OF $135,367.24 CLAIMED BY PETITIONER ON ITS FEDERAL INCOME TAX RETURN FOR THE YEAR 1957 FOR DEPRECIATION FOR THE PERIOD JANUARY 1, 1957, TO DECEMBER 23, 1957, WITH RESPECT TO THE DEPRECIABLE ASSET WHICH PETITIONER SOLD TO A COMPETITOR ON DECEMBER 23, 1957, PRIOR TO THE EXPIRATION OF THE ESTIMATED "USEFUL LIFE" OF SUCH ASSET.

A. Nature of the controversy.

The sole issue in this case involves a determination whether petitioner is entitled to the deduction of $135,367.24, which petitioner claimed on its federal income tax return for its taxable year 1957, for depreciation for the period January 1, 1957, to December 23, 1957, with respect to the *S.S. Joseph Feuer* (the "*Feuer*"), a Liberty-type dry cargo ship, which petitioner sold to a competitor for $695,500 on December 23, 1957. This determination in turn depends upon whether, as a matter of law, the sale price received for the *Feuer*, which exceeded the undepreciated cost of the vessel on January 1, 1957, determined the "salvage value" of the ship for purposes of computing depreciation in the year of sale, as the respondent contends and as the Tax Court and a majority of Court of Appeals concluded, or whether the sale price merely reflected the market value, and not the "salvage value," of the ship at a particular point in time prior to the expiration of the estimated "useful life" of the ship, as the petitioner and the undersigned attorneys contend.

The pertinent facts may be summarized briefly as follows:[4] Petitioner was organized in 1946 and owned and operated ships for charter to exporters for the shipment of dry bulk cargoes in foreign commerce. (R. 3, 7-8.) On December 21, 1955, petitioner purchased the *Feuer* for $469,000 (R. 4) and thereafter operated it under the American flag as a tramp ship for the carriage of various dry commodities from the United States to Asian and African ports. (R. 7-8.)

Prior to purchasing the *Feuer*, the petitioner applied for and received from the Engineering and Valuation Branch of the Internal Revenue Service a letter ruling dated December 8, 1955, with respect to its depreciation. (R. 4.) The ruling stated that the Internal Revenue Service would accept a "useful economic life" of three years from the date of acquisition and a "salvage value" of $5 per dead weight ton ($54,000) for the *Feuer* and that the *Feuer's* cost of $469,000, less its $54,000 "salvage value", should be spread ratably over its three-year "useful economic life". (R. 4.)

Petitioner claimed deductions for depreciation of the *Feuer* on its federal income tax returns for the years 1955 and 1956 in the respective amounts of $3,786.50 and $138,-585.77, leaving an undepreciated cost of $326,627.73 as of January 1, 1957. (R. 4.) The Internal Revenue Service has audited petitioner's income tax returns for 1955 and 1956 and has accepted the depreciation deductions without adjustment. (R. 5.)

The *Feuer* had been built in 1943 for the United States Maritime Commission for emergency use during World War

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[4]The facts before the Court in this case are thoroughly set forth at pages 19 to 75, inclusive, of the Transcript of Record. Inasmuch as the facts are not disputed in this case, and since the Tax Court accurately and completely summarized the pertinent facts in its Findings of Fact, references herein to the pertinent facts will be to the Tax Court's findings as set forth at pages 3 to 11, inclusive, of the Transcript of Record (hereinafter referred to as "R.").

II (R. 4), as part of an accelerated Liberty-type shipbuilding program. In post-war commerce, Liberty ships carried low-paying bulk commodities, principally grain and coal, were slow and had a low cargo capacity and, faced with mounting competition from modern post-war ships, were rapidly becoming obsolete. (R. 8, 10.) However, the economic and market conditions resulting from the blockage of the Suez Canal in 1956-1957 temporarily relieved the precarious economic position of American flag Liberty-type ships. In fact, during this brief crisis the operation of any type of ocean-going vessel, including American flag Liberty-type ships, became highly profitable, and the temporary scarcity of ships caused sales prices of ships to rise sharply. (R. 5.) In January and February of 1957, purchasers were willing to pay as much as $1,000,000 for American flag Liberty-type ships, and as a result the *Feuer* appreciated in value. (R. 5.)

In June of 1957, a competitor of petitioner, the Isbrandtsen Company, Inc., which was engaged in the business of using Liberty-type ships as tramp carriers of grain and other bulk commodities, offered such an excellent price for the *Feuer* that petitioner decided to sell it. (R. 6.) On June 14, 1957, petitioner entered into a contract for the sale of the *Feuer* to Isbrandtsen for $700,000, which amount was reduced to $695,000 as a result of a change in financing. (R. 6.) The contract called for delivery of the *Feuer* to Isbrandtsen in December of 1957, and petitioner made delivery on December 23, 1957. (R. 6.)

Petitioner had not followed a practice of using ships for a short time and then reselling them while still in good operating condition. (R. 6.) Petitioner had not put the *Feuer* up for sale, but had decided to sell the ship solely because Isbrandtsen had offered such an excellent price. (R. 6.) The contract of sale was entered into halfway through the three-year "useful economic life" established for the *Feuer*

by the letter ruling, and when the *Feuer* was delivered to Isbrandtsen one-third of that "useful life" remained. (R. 6.)

By December of 1957, when petitioner delivered the *Feuer* under the June contract of sale, charter rates had fallen sharply (R. 8-9), competition for dry bulk cargoes was increasing (R. 8, 10), Liberty ships were finding it harder to secure cargoes (R. 10), and prices of such ships had fallen to the level of $400,000 to $500,000 (R. 11), all of which confirmed the *Feuer's* obsolescence and the correctness of the estimates of "useful economic life" and "salvage value" made in the letter ruling. Furthermore, scrap steel prices also were falling, and the scrap value of a Liberty ship was between $53,000 and $60,000 (R. 11), almost exactly as established by the letter ruling.

In its federal income tax return for 1957, petitioner reported gross profit of $289,340 from the operation of the *Feuer* up to the date of sale, and also deducted $135,367.24 for depreciation of the *Feuer* from January 1, 1957, to December 23, 1957 (R. 7), under the formula authorized by the letter ruling and approved for prior years. Respondent never has questioned the originally established three-year "useful economic life" for the *Feuer*, nor has he changed the letter ruling as to such "useful economic life" or as to "salvage value". (R. 5.) Nevertheless, respondent disallowed in its entirety the deduction of $135,367.24 for depreciation of the *Feuer* from January 1, 1957, to December 23, 1957, claimed by petitioner on its income tax return for 1957, on the ground that, as a matter of law, the profitable sale of the *Feuer* barred any depreciation deduction for the year of sale. (R. 7.)

In a single-judge memorandum decision, the Tax Court sustained the respondent's disallowance, admitting in the process that it had discarded the "old, well-established rules re-

lating to depreciation allowances", and announced the novel proposition that whenever a depreciable asset is sold, even in the middle of its estimated "useful life", at an amount substantially in excess of its adjusted basis at the beginning of the year of sale, no depreciation is allowable on the asset for that year. In arriving at this new doctrine, the Tax Court relied on three higher court decisions which it erroneously thought had rejected the "old, well established rules": *viz.* the companion decisions of this Court in *Massey Motors, Inc. v. United States,* 364 U.S. 92 (1960), and the decision of the Court of Appeals for the Sixth Circuit in *Cohn v. United States,* 259 F.2d 371 (6th Cir. 1958). (R. 17-18.)

In a two-to-one decision, the Court of Appeals affirmed the judgment of the Tax Court. A majority of the Court accepted the respondent's position that, as a matter of law, a taxpayer is not entitled to a deduction for depreciation in the year of sale with respect to depreciable property sold at a profit, citing only the *Cohn* decision. (R. 78-79, 81.)

Simply stated, the propositions adopted by the Tax Court and by a majority of the Court of Appeals are that, as a matter of law, the sale of a depreciable asset conclusively terminates the previously estimated "useful life" of the asset, and the sale price received for the asset supplants any previously estimated "salvage value" of the asset for purposes of computing depreciation on the asset in the year of sale.

B. The decision of a majority of the Court of Appeals is based upon a complete misunderstanding of fundamental accounting principles of depreciation which are embodied in the basic statutory provision and which have been recognized, enunciated, refined, and followed by this Court.

Two entirely distinct concepts of the term "depreciation" are often confused. Under the dictionary definitions[5] as used in relation to problems not here involved, the term "depreciation" is the converse of *appreciation* and thus means a decline in value not necessarily attributable either to use or to lapse of time. A majority of the Court of Appeals applied this meaning to the word as used in the applicable income tax statute. Its conclusion that, as a matter of law, depreciation is not allowable in the year of the profitable sale of a depreciable asset springs from its premise, unsupported, as we shall see, by statutory, judicial or accounting authority, that "the purpose of the depreciation allowance is to enable the taxpayer to recover the net cost of a wasting asset used in his trade or business by charging *the diminution in the asset's value* each year against the gross income for that year"[6] and that "all that is required is a comparison of the asset's selling price with its adjusted basis" to determine whether or not the asset "costs a taxpayer" anything in the year of sale and, therefore, has "depreciated" in that year for tax purposes.[7]

Accounting authorities have developed recognized concepts of "useful life" and "salvage value" for depreciation purposes. "The useful life of depreciable assets is based on their period of usefulness to the company and not their in-

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[5]Webster's Seventh New Collegiate Dictionary 222 (1963) defines "depreciate" as ". . . to lower the price or estimated value of" and "to fall in value".

[6]R. 80. Italics supplied.

[7]R. 81.

herent life."[8] A "cycle of life is comprehended in the whole period of usefulness of an article in a given position."[9] "Useful life may be less than physical life because of such factors as obsolescence and inadequacy."[10] The service lives of plant and properties may be limited by a variety of physical and functional factors.[11]

"Salvage value" is the "value an article possesses for some use other than that to which it has been devoted."[12] This will be merely junk or scrap value unless the article possesses "another cycle of life."[13] The article "depreciates until it reaches its salvage or scrap value, as the case may be," beyond which point "there is no further depreciation because it enters a second cycle of life or is broken up . . . ."[14]

"Original cost is usually the only factor known definitely which is employed to compute the depreciation charge for a given period. Useful life and salvage value must be estimated."[15] The accounting recognition of depreciation is "necessarily . . . based upon an estimate of useful life."[16] "Salvage value", like "useful life", should be estimated at the time of acquisition."[17] Accounting authorities recognize

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[8]MONTGOMERY, AUDITING 271 (8th Ed. 1957) (hereinafter cited as "MONTGOMERY").

[9]SALIERS, DEPRECIATION: PRINCIPLES & APPLICATIONS 74 (hereinafter cited as "SALIERS").

[10]MONTGOMERY at 268.

[11]PATON, ACCOUNTANTS' HANDBOOK 720 (3d Ed. 1944) (hereinafter cited as "PATON").

[12]SALIERS at 72.

[13]*Ibid.*

[14]*Ibid.*

[15]SALIERS at 130.

[16]MONTGOMERY at 268.

[17]*Id.* at 271.

that "past recoveries on similar assets may provide the basis for an estimate."[18]

Depreciation accounting is from the outset a process of dead reckoning. However, the accounting authorities recognize that the "useful life" of an asset, and thus the depreciation rate, is subject to correction—prospectively—when the evidence clearly indicates that correction is required.[19] Significantly, although the accounting authorities specifically contemplate appropriate prospective changes in estimated "useful life", the authorities do not contemplate changes in the original estimates of "salvage value". To the contrary, they make it abundantly clear that changes in "salvage value" should not be dictated by or be based upon changes in price levels or market values, *whether or not realized through sale of the asset.*[20]

Accountants strenuously object to changes in depreciation accounts to reflect current values. The objections are, in part, based on impracticability,[21] awkwardness and the desire to avoid "radical and tedious adjustments."[22] But the fundamental objection is that the adjustment of depreciation to differences in value at the beginning and end of the accounting period "violates the basic concept of depreciation because it does not fairly allocate the cost of depreciable

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[18] *Id.* at 272.

[19] MONTGOMERY at 271; PATON at 279; SALIERS at 130, 132; Braunstein & Johnson, *Public Utility Depreciation and the Income Tax*, 52 HARV. L. REV. 1077, 1087-88 (1939).

[20] 1 DEWING, THE FINANCIAL POLICY OF CORPORATIONS 537 n. f (5th Ed. 1953) (hereinafter cited as "DEWING"); SALIERS at 61, 68-69.

[21] Accounting Research Bulletin No. 43, ch. 9(A) (Committee on Accounting Procedure, American Institute of Certified Public Accountants, 1953).

[22] SALIERS at 374.

property to income over its useful life."[23] For depreciation accounting is "a process of allocation, not of valuation."[24]

An equally serious objection is that recognition of changes in fair market value would introduce extraneous elements into the depreciation equation. Depreciation for the year "is not intended to be a measurement of the effect of all . . . occurrences."[25] Various elements "to be considered in determination of fair value" are "not necessarily reflected in correct accounting practice. . . ."[26] One such extraneous element is the appreciation resulting from changing price levels or from increased demand or productivity. A valuation may "show that present value of plant is as much as or greater than cost . . . not because depreciation does not exist, however, but because appreciation in some parts has occurred or because a going-concern value has been established."[27] "The impropriety of offsetting depreciation by appreciation is regarded as axiomatic by most accountants."[28]

Clearly, increase in value does not necessarily reflect over-depreciation. And it is equally clear that the sale or other disposition of depreciable property at a profit does not necessarily reflect over-depreciation. "The treatment of the property account in the case of a sale should conform precisely to the treatment required in the case of any retirement. . . . The amount in the depreciation allowance applicable to the particular unit retired should be charged off, and the balance

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[23]Montgomery at 273.

[24]See note 35 *infra* and accompanying text.

[25]*Ibid.*

[26]Saliers at 71.

[27]*Id.* at 46-47.

[28]Paton at 718.

should be treated as a special profit . . . item."[29] If, for example, a machine having a cost of $1,100, a 10-year estimated "useful life" and an estimated "salvage value" of $100 is retired at the end of the ninth year, nine full years' depreciation ($900) should be charged.[30] The profit or loss upon retirement should be reflected in a "special profit or special loss account" rather than in the depreciation account, so that it "can be excluded from the current expense and revenue data."[31] Some modification of this treatment of retirements might be justified only "where the loss or profit appears to be due to the understatement or overstatement of depreciation throughout the elapsed life rather than to some current and unusual development."[32]

These principles have peculiar force with respect to dispositions in the middle of the estimated "useful life", where the sale price may reflect increased earning capacity. "[P]otential excess of earning capacity may be represented in the accounts . . . when a business is . . . sold. . . . *But this has nothing to do with accounting for depreciation.*"[33]

Accounting authorities recognize that the annual charge for depreciation cannot accurately be measured in terms of a year's actual exhaustion, wear, tear, and obsolescence, since, in the usual case, the monetary impact of these factors, either alone or in combination, cannot for a given year be

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[29] *Id.* at 685.

[30] *Id.* at 742. The author also notes the Internal Revenue Service practice of requiring calculation of depreciation to the day of retirement. *Id.* at 773.

[31] *Id.* at 777.

[32] *Ibid.*

[33] DEWING at 581 n. mmm. Italics supplied.

expressed with reasonable certainty.[34] Thus, these authorities, recognizing that an asset in fact deteriorates with use and the passage of time, hold that the cost of the asset (less its estimated "salvage value") must be allocated over its estimated "useful life," in the expectation that the portion of the cost allocated to and charged against income for a particular year will, as nearly as possible, approximate the average monetary impact on the business of physical and functional deterioration for that year. Accordingly, the well-established accounting concept of depreciation is expressed as follows:

> *Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. *Depreciation for the year* is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.[35]

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[34] See Accounting Terminology Bulletin No. 1, ¶ 54 (Committee on Terminology, American Institute of Certified Public Accountants, 1953), republished in Accounting Terminology Bulletin No. 1, *Review and Resume*, ACCOUNTING RESEARCH & TERMINOLOGY BULLETINS ¶ 54, at 24-25 (American Institute of Certified Public Accountants, Final Ed. 1961).

[35] Accounting Terminology Bulletin No. 1, ¶ 56 (Committee on Terminology, American Institute of Certified Public Accountants, 1953), republished in Accounting Terminology Bulletin No. 1, *Review and Resume*, ACCOUNTING RESEARCH & TERMINOLOGY BULLETINS ¶ 56, at 25 (American Institute of Certified Public Accountants, Final Ed. 1961); FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 440 (4th Ed. 1951); KARENBROCK & SIMONS, INTERMEDIATE ACCOUNTING 315 (3d Ed. 1958); MONTGOMERY, AUDITING 260 (7th Ed. 1949). Italics in original. For other authorities recognizing an almost verbatim accounting principle, see, *e.g.*, Cranstoun, *Tangible Fixed Assets*, CONTEMPORARY ACCOUNTING 2, 5 (1945); CURRENT PRACTICE IN ACCOUNTING FOR DEPRECIATION: NATIONAL ASSOCIATION OF ACCOUNTANTS RESEARCH REPORT 3-4 (1958); KENNEDY & MCCULLEN, FINANCIAL STATEMENTS—FORM, ANALYSIS & INTERPRETATION 159 (4th Ed. 1962).

The conclusion is clear. Under well-established accounting principles which, as we shall see, have been embodied in the basic statutory provision, and previously applied by this Court, the sales price received by a taxpayer on the sale of his depreciable assets is not an element in the determination of the taxpayer's deduction for depreciation for the year of sale, regardless of the amount of the sale price, and the gain (or loss) realized on the sale is accounted for separately.

The meaning of the term "depreciation" for income tax purposes is plainly expressed in the basic statutory provision, Section 167(a) of the Internal Revenue Code of 1954, which provides as follows:

> (a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the *exhaustion, wear* and *tear* (including a reasonable allowance for *obsolescence*)—
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> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.[36]

The present statutory language flows uninterruptedly[37] from the Revenue Act of 1918, which authorized deduction of a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."[38] Allowing for minor variations in phraseology, the statutory deduction for depreciation dates back even further, to the origin of the modern income tax in the Revenue Act of 1913, which gave individuals a "reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the busi-

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[36]Italics supplied.

[37]INT. REV. CODE OF 1954, §167(a); Int. Rev. Code of 1939, §23(1); Rev. Acts of 1934, 1936, and 1938, §23(1); Rev. Acts of 1928 and 1932, §23(k); Rev. Acts of 1921, 1924, and 1926, §214(a)(8). Rev. Act of 1942, §121(c), expanded the scope of this provision to include property held for the production of income.

[38]Rev. Act of 1918, §214(a)(8).

ness" and corporations a "reasonable allowance for depreciation by use, wear and tear of property, if any".[39]

Neither Section 167(a) nor its legislative antecedents define depreciation in terms of valuation. On the contrary, these statutory provisions take into account the obvious fact that property deteriorates physically and functionally with time and use and define depreciation as an allowance for "exhaustion, wear . . . tear . . . [and] obsolescence." Each year, twelve months' worth of "exhaustion, wear and tear" is totalled up. This is the price the taxpayer pays for owning and using property in his trade or business. This occurs regardless of the market value of the property. Whether that value goes up or down, the elements do their work. Moreover, most property becomes obsolete at varying rates with the passage of time, wholly apart from its physical deterioration.

What happens when a depreciable asset is sold in the middle of a year for an amount in excess of its depreciated basis at the beginning of the year of sale? Does this mean that the property has not sustained any "exhaustion, wear and tear" during the year of sale? Does this mean that even though the property was used during the year prior to its sale and was somewhat older than it was at the beginning of the year the elements as of the beginning of the year of sale suddenly ceased to take their toll? Of course it does not. The asset has continued to depreciate and it always will. The sale price received for the asset does not change the wear and tear upon it.

The emphasis of this Court has been on the taxable year as a unit, and depreciation is to be taken in each year of the depreciating asset's "useful life". In *Virginian Hotel Corp.*

[39]Rev. Act of 1913, §§ IIB and IIG, respectively.

v. Helvering, 319 U.S. 523, 526, 528 (1943), this Court stated that:

> Congress has elected to make the year the unit of taxation. . . . Thus the amount "allowable" must be taken each year. . . . Congress has provided for deductions of annual amounts of depreciation which, along with salvage value, will replace the original investment of the property at the time of its retirement.

Moreover, in *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960), and *Hertz Corp. v. United States*, 364 U.S. 122, 126 (1960), this Court recognized that "it is the primary purpose of depreciation accounting to further the integrity of periodic income statements. . . ." Finally, in *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943), this Court observed that "it is sound accounting practice annually to accrue" an aliquot part of the total depreciation allowable over the estimated "useful life" of the depreciating asset.

The effect of the decisions of the lower courts in this case is to destroy the integrity of the periodic income statements through offsetting allowable depreciation in the year of sale against realized appreciation without giving to each class of item the special recognition and treatment intended by the tax statute.

In early cases interpreting the Corporation Excise Tax Act of 1909, this Court announced that the statutory depreciation allowance was for depreciation as "charged in practical bookkeeping."[40] In the Court's view, Congress used the expression "depreciation of property" (which in the 1909 statute was not given any definition similar to that provided

[40]This view, first discussed by this Court in Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 423 (1913), was decisively adopted in Von Baumbach v. Sargent Land Co., 242 U.S. 503, 524 (1927).

in 1913 and subsequent years[41]) in the tax statute in "its ordinary and usual sense as understood by businessmen."[42] The Court added that it "is common knowledge that business concerns usually keep a depreciation account, in which is charged off the annual losses for wear and tear, the obsolescence of structures, machinery and personalty in use in the business," and reiterated that "Congress . . . used the term 'depreciation' in its ordinary and usual significance."[43] This Court has more recently observed, in a case involving the modern statutory language, that the connotations of the income tax allowance for obsolescence are those of "accounting and engineering terminology."[44] Since "depreciation is fundamentally an accounting postulate,"[45] the accounting authorities reviewed above are as relevant to this case as the judicial and administrative precedents.

This Court, in interpreting the Revenue Act of 1916[46] in *United States v. Ludey,* 274 U.S. 295 (1927), reviewed the fundamental principles that control the income tax allowance for depreciation. The Court observed that the depreciation allowance "permitted as a deduction from the gross income in determining the taxable income for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used."[47] The measure of

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[41]Corp. Excise Tax Act of 1909, §38 (Second), permitted deduction of a "reasonable allowance for depreciation of property, if any."

[42]Von Baumbach v. Sargent Land Co., 242 U.S. 503, 524 (1927).

[43]*Id.* at 524-25.

[44]Real Estate Title Co. v. United States, 309 U.S. 13, 16 (1940).

[45]DEWING at 535 n. a.

[46]The 1916 Act authorized deduction of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade." Rev. Act of 1916, §§ 5(a) (Seventh) and 12(a) (Second).

[47]274 U.S. at 300.

this allowance "is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with salvage value) suffice to provide an amount equal to the original cost."[48] Mr. Justice Brandies then neatly summarized the concept on which depreciation accounting rests:

> . . . The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of the properties.[49]

See also *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943).

It was not until 1960 that this Court had the occasion to analyze the concepts of "useful life" and "salvage value" in terms of the depreciation formula first enunciated by the Court in *Ludey*. In that year the Court handed down its decisions in *Massey Motors, Inc. v. United States*, (decided with *Commissioner v. Evans*), 364 U.S. 92 (1960), and *Hertz Corp. v. United States*, 364 U.S. 122 (1960). The *Massey* and *Hertz* decisions determined the depreciation allowable to taxpayers whose past experience had clearly indicated a consistent utilization of assets for a substantially shorter period than their full physical or economic life. The two decisions covered five fact situations, all involving depreciation of new automobiles.

In each of the five fact situations, the automobiles were regularly sold long before the end of their full physical or

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[48] *Id.* at 300-01.

[49] *Id.* at 301.

economic life. They were sold after the described limited use because demands by customers or other users for later models rendered unsuitable the continued use of the older models in the taxpayers' businesses. In each case the resale price regularly obtainable at the end of such limited use was substantial.

The issue before this Court in the *Massey* and *Hertz* cases was the proper estimated "useful life" and "salvage value" to be used under such circumstances in computing depreciation on the automobiles from the outset of their use. The taxpayers claimed depreciation on their tax returns on the basis of a "useful life" measured by the "estimated physical life" of the automobiles and on the basis of no "salvage value" at the expiration of such period. The Government, on the other hand, defined the term "useful life" for purposes of computing depreciation on the automobiles as "the period during which the taxpayer *anticipates* actually retaining the" automobile in the business.[50]

This Court upheld the Government's position and held that the "useful life" of the automobiles for depreciation purposes was the period of their *reasonably expected* use in the business, as shown by the taxpayers' prior experience with similar automobiles, rather than the full economic or physical life of the automobiles, because the automobiles were "not acquired with intent to be employed in the business for their full economic life."[51] The Court made it clear that the intent not to use assets in the business for their full economic life could be inferred from the practice of the taxpayers of consistently selling such assets prior to the end of such economic life, when it stated that "It is this type of asset, where the *experience of the taxpayer* clearly indicates a utilization of

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[50] 364 U.S. at 109. Italics supplied.

[51] *Id.* at 96-97, 105, 107.

the assets for a substantially shorter period than its full economic life, that we are concerned with in these cases."[52]

In terms of "useful life" for depreciation purposes, the Court made it clear that its holding was expressly limited by the definition of "useful life" urged by the Government to a situation where assets are acquired "with intent" that such assets will be "employed in the business" for a period less than the full economic life of such assets and where such intent can be inferred from the consistent practice of the taxpayer of selling such assets substantially prior to the end of their full economic life. For the Government contended, and the Supreme Court agreed, that "useful life" means "the period during which the taxpayer anticipates actually retaining the assets" in the business.[53]

Consistently with its holding on the issue of "useful life," this Court also held that the "salvage value" of the automobiles was the amount which could be expected to be obtained by the taxpayers on resale when the automobiles were no longer useful as rental or company cars. This Court said that Congress "intended that the taxpayer should, under the allowance for depreciation, recover only the cost of the asset less the *estimated* salvage, resale or second-hand value" and that "salvage value must include *estimated* resale or second-hand value."[54] We believe it is clear that the Court was thus discussing the *estimation* of "salvage value" for a new asset; its use of the words "estimated . . . resale or second-hand value" appears to convey the Court's view that

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[52] *Id.* at 96-97. Italics supplied.

[53] *Id.* at 109. See also *The Motorlease Corp. v. United States*, 215 F. Supp. 356, 360 (D. Conn. 1963), *rev'd*, 334 F.2d 617 (2d Cir. 1964), *petition for cert. filed* (No. 685, 1964 Term; renumbered No. 24, 1965 Term); Andrew J. Easter, 23 CCH Tax Ct. Mem. 413, 417 (1964); Katherine Slider, 20 CCH Tax Ct. Mem. 1327, 1329 (1961); John W. Roddy, 20 CCH Tax Ct. Mem. 1129, 1131 (1961).

[54] 364 U.S. at 107. Italics supplied.

"salvage value" should not be set at scrap value where the taxpayer's habitual past practice has been to resell the assets for substantial sums for further use. It appears from the Court's opinion in *Massey* that the Court fixed the "salvage value" of the rental and company cars as the resale price which it might be *anticipated* would be obtainable at the end of the properly *estimated* "useful life" of the cars when the cars were no longer useful as rental or company cars.

The Court noted in *Massey* that the traditional accounting formula for depreciation had had the Court's approval since *United States v. Ludey*.[55] Indeed, the Court built its *Massey* and *Hertz* opinions upon the depreciation formula of the *Ludey* case. The *Massey* and *Hertz* opinions do nothing more than refine that formula by making it clear that "useful life" and "salvage value" of newly-acquired assets must be related, where possible, to the taxpayer's past experience with respect to similar assets.

Thus, the depreciation formula adopted and refined by this Court is clear: The allocable sum is original cost less the amount which the taxpayer estimates at the time of acquisition will be the value of the property at the end of its estimated "useful life," and the rate of allocation is the period for which the taxpayer, again at the time of acquisition, reasonably anticipates the property will be useful in the business.

If this Court were to approve the contentions of the respondent the results in many cases would be highly mechanical and arbitrary. For example, a taxpayer on a calendar year basis who negotiates and completes a sale of depreciable property in January would suffer little or no penalty compared to that he would have suffered if he had negotiated and

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[55] *Id.* at 104.

completed the sale in the previous December. In the former case, the depreciation disallowed would be that attributed to a fraction of a month, and in the latter case it would be the depreciation attributed to 11 and a fraction months. And if two depreciable assets are sold, one at a profit and one at a loss, depreciation would be disallowed on the profitable sale and allowed on the loss sale thus decreasing the gain and leaving the loss unchanged, despite the fact that Congress, in Section 1231(a) of the 1954 Code, has made special provision requiring taxpayers to offset net losses against net gains in computing gains or losses recognizable under that provision.

C. The lower courts in this case misinterpreted two decisions of this Court and a decision of the Court of Appeals for the Sixth Circuit.

The Tax Court in this case concluded that the "old, well established rules relating to depreciation allowances" had been discarded by this Court in *Massey* and *Hertz* and by the Court of Appeals for the Sixth Circuit in *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958),[56] and a majority of the Court of Appeals concluded that respondent's new theory, while admittedly "logically inconsistent",[57] was "strongly suggested"[58] and "adequately supported"[59] by the *Cohn* decision, although it conceded that the *Cohn* decision "could have been more explicit".[60]

It is obvious that the problem before this Court in *Massey* and *Hertz* had absolutely nothing to do with a subsequent

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[56]R. 17-18.

[57]R. 78.

[58]R. 78.

[59]R. 79.

[60]R. 79.

redetermination of "salvage value" upon sale in the middle of "useful life". But respondent apparently views this Court's decisions in those cases as supporting his new theory that "useful life" is the period of actual use and that "salvage value" is sale price whenever obtained. However, in those cases the Government urged, and the Court agreed, that "useful life" means "the period during which the taxpayer anticipates actually retaining the assets" in the business.[61] This view, in complete negation of respondent's new "actual use" theory in determining "useful life",[62] was reiterated in the opinion written in dissent in *Massey* and in concurrence in *Hertz:*

> "In examining the cases, it must be borne in mind that even the Commissioner does not contend that a taxpayer who *happens* to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held. It is only when the asset "may reasonably be expected" to be disposed of prior to the end of its physical life that the taxpayer must base depreciation on the shorter period. Reg. Section 1.167(a)-1(b). Therefore, the only cases relevant in this regard are those in which the taxpayer's past experience indicated that assets would be disposed of prior to becoming junk, thus presenting the issue whether the shorter or longer period should control for purposes of depreciation.[63]

Furthermore, it is equally clear that in *Massey* and *Hertz* the Court did not hold that "salvage value" is conclusively

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[61]364 U.S. at 109.

[62]It is worth noting that respondent himself did not initially interpret this Court's decision in *Massey* to equate "useful life" with actual use. In *John W. Roddy*, 20 CCH Tax Ct. Mem. 1129 (1961), respondent contended, and the Tax Court agreed, that this Court's decision in *Massey* supported respondent's determination that the taxpayer's depreciation deductions with respect to a total of 623 automobiles sold in 1953, 1954, and 1955 should be computed on the basis of an estimated "useful life" for 18 months, even though the taxpayer's actual holding periods for the automobiles sold ranged from *3 months* to *43 months*.

[63]364 U.S. at 113. Italics in original.

fixed by sale price whenever obtained. The Government did not even argue such a proposition in either case. Indeed, in calculating the tax deficiencies of one of the two taxpayers involved in the *Massey* decision,[64] respondent used an estimated "salvage value" of $1,325 for 140 automobiles sold in the same year for $1,380, thereby permitting the automobiles to be depreciated during the year of sale to levels beneath the sales prices received for them. The minor dollar point assumed or conceded by respondent in *Massey* now becomes the sole issue in this case, but clearly the Court in *Massey* did not state or even hint at agreement with respondent's present position. This Court, not having been faced in *Massey* and *Hertz* with the unanticipated sale of an asset substantially prior to the expiration of its properly estimated "useful life", could not possibly have passed on the issue here. It is clear from the Court's opinion in *Massey* that it fixed the "salvage value" of the automobiles as the resale price *which it might reasonably be anticipated at the time of acquisition* would be obtainable at the end of the properly estimated "useful life" of the automobiles when they were no longer useful in the business, and not the amount which might be received on a sale at a prior time.

It is clear that the decision of the Sixth Circuit in *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958), neither departed from the "old, well established rules relating to depreciation allowances" nor supports the opinions of the lower courts in this case. In *Cohn*, the taxpayers commenced the operation of three flying schools for the Army Air Corps in 1941. In 1942 taxpayers reconsidered the "useful life" of its assets, and in the taxpayers' return for 1942 it was asserted that "useful life" would terminate on December 31, 1944, and ad-

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[64] *Evans v. Commissioner*, 264 F.2d 502 (9th Cir. 1959), *rev'd sub nom., Massey Motors, Inc. v. United States*, 364 U.S. 92 (1960).

ditional depreciation was claimed in returns for the years 1942, 1943 and 1944 on that basis. The taxpayers in their returns did not take "salvage value" into account, although operators of similar schools customarily computed depreciation on the basis of an estimated "salvage value" equal to 10 percent of original cost. Respondent set up deficiencies for 1942, 1943 and 1944 by lengthening the estimates of "useful life" but without requiring the taxpayers to take "salvage value" into account. The district court upheld the taxpayers' revised estimates of "useful life" as claimed in their returns, but it also held that in computing depreciation for the year of sale the taxpayers should use a "salvage value" equal to the sale prices received when the assets were sold in 1944. The taxpayers appealed the latter determination to the Sixth Circuit.

In the light of these facts, the scope and meaning of the decision of the Sixth Circuit in *Cohn* are readily discernible: "salvage value" could be redetermined *because*, at the taxpayers' insistence, the "useful life" had been redetermined. The following passage from the brief which the Government filed with the Sixth Circuit in that case makes this at once apparent:

> "*Here, taxpayers sought an adjustment of their depreciation deduction to correct an error in their estimate of the useful lives of the assets in question and the court made this correction in their favor.* At the same time, however, taxpayers seek to cut off any adjustment of an obvious error in their estimate of salvage value. Surely, when the correctness of the amount of a depreciation deduction for a particular year or years is placed in issue, the Commissioner and the Courts are not precluded from looking to all of the factors involved in the computation of the deduction in order to make any adjustment necessary to reach the correct amount of depreciation for that, and future, years. Taxpayers' contention seeks to obtain an adjustment only insofar as it aids them and

to preclude an adjustment in the Commissioner's favor, thereby preventing the court from determining the correct amount of the deduction. *If taxpayers can adjust the length of the assets' estimated useful lives to fit the realities of the situation, no logical reason presents itself as to why the Government and the court cannot do the same with respect to estimated salvage value.* . . . Although the cited Regulations (Section 1.167(a)-1(c), promulgated under the Internal Revenue Code of 1954), state that salvage value may not be changed merely because of a change in price levels, they also provide that, *if there is a redetermination of useful life,* the salvage value may be redetermined, based upon facts known at the time the useful life is redetermined and, furthermore, they provide that in no event shall the asset be depreciated below a reasonable salvage value. *That is precisely the rule of this case; the useful life was redetermined by the court, and at the time, the salvage value was redetermined* in light of the facts known at the end of the tax year involved; upon this redetermination, the court disallowed any depreciation in excess of the reasonable salvage value found by it.[65]

Presumably in response to the above statement by counsel for the Government, the Sixth Circuit stated:

But the Government is not contending that salvage value should be adjusted annually in order to conform with current market values, or that it should be adjusted at all on account of "mere fluctuation in market value". In so far as this case is concerned *the issue is whether salvage value can be adjusted at or near the end of the useful life of the asset* when it is shown by an actual sale of the asset that there is a substantial dif-

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[65]Brief for the Appellee, pp. 24-26, in *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958). Italics supplied. In addition to the remarks contained in the passage of the Government's brief quoted above, the Government also argued that "the District Court did no more than find that the reasonably estimable salvage value was, on the facts of this case, equal to the amounts actually received on the sale of the assets involved", and expressly recognized that the district court's "finding was solely predicated on the facts of this case and, on a different set of facts, it is. of course, possible that an entirely different finding would result." Brief for the Appellee, p. 32, in *Cohn v. United States, supra.*

> ference between what was estimated and what it actually is. We are not concerned with mere fluctuations or with any fluctuations from year to year. On the contrary, we have a single and final adjustment in the closing of the books on the asset involved. Under such circumstances the practical difficulties urged upon us are largely nonexistent.[66]

The Sixth Circuit reviewed the "well settled principles governing depreciation deductions." "Useful life", said the Court, "is the period over which the assets may reasonably be expected to be useful to the taxpayer in his trade or business"; because the "property may still have some value when it has completed its usefulness to the business, which will be realized by the taxpayer by its sale at the end of its useful life, it is necessary that this salvage value be deducted from the cost in order to find the net amount which is to be amortized over the years the property is to be used in the business"; and "useful life" and "salvage value" are necessarily estimates "made at the time when the property is first put to its business use."[67]

The Sixth Circuit, after reviewing these settled principles, then considered taxpayers' "fundamental contention" that "salvage value", having been determined at the time of acquisition, cannot be redetermined at any time thereafter. The Sixth Circuit decided that the district court could change "salvage value" *because* it had redetermined "useful life", and then restated and adopted the argument made in the Government's brief. Acknowledging that, in appropriate circumstances under the rule in Section 1.167(a)-1(c) of the Treasury Regulations, depreciation based on estimates of "useful life" and "salvage value" could "be reconsidered through a redetermination of useful life," and that *"at least*

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[66]259 F.2d at 378. Italics supplied.

[67]*Id.* at 377.

at the same time, a reconsideration and redetermination of salvage value" could be made,[68] the Court of Appeals concluded that:

> ***Appellants, in filing their actions in the District Court, put in issue the depreciation deductions claimed by them and disallowed by the Commissioner.*** **In deciding that issue under the circumstances of this case, we are of the opinion that the District Judge was not in error as a matter in law *in considering both useful life and salvage value.* If so, his findings of fact with respect to salvage value are fully supported by the evidence, are not clearly erroneous, and must be sustained.**[69]

For respondent now to seize the *Cohn* decision and seek to transform what plainly was a narrow finding of fact into an absolute and sweeping rule of law is obviously unjustified. His reliance on the *Cohn* case requires him to equate "salvage value" at the end of originally estimated "useful life" with actual sale price at mid-life. Respondent thus assumes his conclusion, a conclusion not justified by the holding of the case itself. Under the circumstances in *Cohn*, *viz.*, a redetermination of "useful life" and a sale at or near the end of such "useful life", the court's treatment of the proceeds of such sale as "salvage value" provides no support for the proposition that sale price, irrespective of when obtained, necessarily equals "salvage value". The equivalence of these two concepts, which a majority of the Court of Appeals in this case erroneously considered to be "strongly suggested" and "adequately supported" by *Cohn*, remains respondent's unsupported assumption, and in view of the holding of the Sixth Circuit, narrowed in accordance with the Government's own urging, this supposed equivalence appears to be an erratic afterthought on the part of respondent.

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[68] *Id.* at 378. Italics supplied.

[69] *Id.* at 379. Italics supplied.

It seems clear that the courts in the *Cohn* case would not have permitted a redetermination of "salvage value" which (a) did not occur at or near the end of the "useful life" of the asset, and (b) was not made under circumstances in which a redetermination of "useful life" was permitted. While it might be argued that the district court in the *Cohn* case should have redetermined "salvage value" in the light of the facts known in 1942 when "useful life" was redetermined and without regard to the facts known in 1944, this error (if it be one) obviously does not have any application to the facts in this case where the sale was made at mid-life, and neither petitioner nor respondent had sought or are seeking a redetermination of "useful life". In the light of this comment, the holding of the Sixth Circuit in *Cohn* as quoted above is particularly pertinent in that the Court of Appeals held that the district judge was not in error as a matter of law in considering both "useful life" and "salvage value". Having made this holding, the determination of the precise "salvage value" was clearly a fact question and, as stated by the Sixth Circuit, the value found by the district court was not clearly erroneous and must be sustained.

The essence of petitioner's position in this case is that in the facts of this case "useful life" and therefore "salvage value", as a matter of law, may not be redetermined, and therefore the Tax Court should never have reached the fact question as to what the "salvage value" of the *Feuer* was at the time of sale. If it be assumed that contrary to all of the principles recognized by accounting authorities and the courts, the lower courts in this case can redetermine "useful life" and "salvage value" because of the sale, it does not follow that the sale price (at mid-life) is trustworthy evidence of "salvage value", inasmuch as the sale price in this case was not received at or near the time as of which "salvage value" is to be estimated, *viz.*, at the end of estimated "useful life".

D. The Treasury Regulations are entirely consistent with well-established principles of depreciation accounting and were misinterpreted by the lower courts in this case.

The Treasury Regulations promulgated under Section 167 (a) simply mirror the well-established accounting concepts of depreciation accounting and adopt the depreciation formula of the *Ludey* case as refined by this Court in *Massey* and *Hertz*. The pertinent provisions of these regulations are reprinted in the Appendix. It will suffice here to summarize the thrust of these provisions. In Section 1.167(a)-1(a) the purpose of the depreciation allowance is expressly recognized to be to provide "for the *exhaustion, wear and tear, and obsolescence* of property used in the trade or business or of property held by the taxpayer for the production of income"[70] and it is stated that "the allowance is that amount which should be set aside for the taxable year . . . so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the *estimated* useful life of the depreciable property, equal the cost or other basis of the property".[71] For this purpose, Section 1.167(a)-1(b) of the regulations defines estimated "useful life" of an asset as "the period over

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[70]Italics supplied. Respondent's interpretation of the term "depreciation" for income tax purposes as physical and functional deterioration of property, as opposed to a reduction in value, finds ample precedent on the first page of respondent's Bulletin "F" (as revised in January, 1942):

> . . . The production of net income usually involves the use of capital assets, which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption usually is gradual, extending over a period of years. *It is ordinarily called depreciation*, and the period over which it extends is the normal useful life of the asset. [Italics supplied.]

[71]Italics supplied. The depreciation formula set forth in the quoted portion of respondent's regulations clearly recognizes depreciation accounting as a process of cost allocation, not of asset valuation, and respondent has made his position in this respect crystal clear in Rev. Proc. 62-21 (Part II), 1962-2 Cum. Bull. 418, 429, where he stated:

> . . . The purpose of the allowance [for depreciation] is to permit taxpayers to recover through annual deductions the cost (or other basis) of the property over its useful economic life.

which the asset *may reasonably be expected* to be useful to the taxpayer in his trade or business".[72] In determining his reasonable expectation of use of depreciable property, the taxpayer is specifically required by Section 1.167(a)-1(b) to consider, *inter alia*, "wear and tear and decay or decline from natural causes", "the normal progress of the art, economic changes, inventions and current developments within the industry and the taxpayer's trade or business," and the taxpayer's experience with similar property. Finally, Section 1.167(a)-1(c) defines "salvage value" as "the amount (*determined at the time of acquisition*) which is estimated will be realizable upon sale or other disposition of an asset"[73] at the end of its estimated "useful life".

Section 1.167(a)-1(c) makes three things clear. First, "salvage value" means the *anticipated* value ("determined at the time of acquisition") of an asset at the end of its anticipated "useful life", also estimated at the time of acquisition, and is thereafter to be redetermined only in extraordinary circumstances. Secondly, in a negative manner, the regulations make it clear that a fluctuation in price levels does not constitute such a circumstance by stating that "salvage value" is not to be redetermined merely because of changes in price levels. In other words, a taxpayer may not increase his annual depreciation deductions to reflect a drop in price levels resulting in a lower estimated "salvage value".[74] In fact, this is expressly forbidden in Section 1.167(a)-1(a) of the regulations where it is stated that the annual "allowance

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[72] Italics supplied.

[73] Italics supplied.

[74] The law is clearly established at the insistence of the Internal Revenue Service that if depreciable assets are sold at a loss, the depreciation deduction is not increased to the extent of the loss. Engineers Ltd. Pipeline Co., 44 T.C. __ No. 25, CCH Tax Ct. Rep., Dec. 27.411 (May 28, 1965); Thos. Goggan & Bro., 45 B.T.A. 218, 224, 225 (1941). See also Rev. Rul. 62-92, 1962-1 CUM. BULL. 29.

[for depreciation] shall not reflect amounts representing a mere reduction in market value." It follows, of course, that the annual allowance for depreciation cannot reflect amounts representing a mere increase in market value, yet this is precisely the position of a majority of the Court of Appeals and of respondent. If mere changes in market value do not affect the determination of the annual allowance for depreciation, the added fact that the change in market value is proved by a sale rather than by some other means should be immaterial. Thirdly, and finally, the regulations state positively that "if there is a redetermination of useful life" under the rules contained in Section 1.167(a)-1(b), "salvage value" may be redetermined on the basis of "facts known to exist at the time of such redetermination of useful life."

Plainly, therefore, once "salvage value" is estimated at the time of acquisition, subsequent events become relevant to justify a change in the originally estimated "salvage value" only in connection with a redetermination of "useful life", and a change in originally estimated "salvage value" is quite clearly forbidden under any other circumstances.

The parenthetical emphasis in Section 1.167(a)-1(c) upon the time when "salvage value" must be determined and the statements as to when it may and may not be redetermined are strengthened when viewed in historical perspective. The originally proposed depreciation regulations under the Internal Revenue Code of 1954, published on September 28, 1954,[75] were followed by the second proposed regulations on November 11, 1955,[76] and thereafter by those finally adopted on June 11, 1956.[77] Significantly, neither the parenthetical statement nor the other italicized portions of Section 1.167

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[75] 19 Fed. Reg. 6229 (1954).

[76] 20 Fed. Reg. 8454 (1955).

[77] T.D. 6182, 1956-1 Cum. Bull. 98, 21 Fed. Reg. 3985 (1956).

(a)-1(c) set forth in the Appendix, as finally adopted, appeared in the earlier proposals. It would be hard to find more explicit evidence of the Treasury's opinion that "salvage value" must be estimated at the time of acquisition and that "salvage value" thus estimated cannot thereafter be redetermined except in connection with a redetermination of originally estimated "useful life".

It is apparent from the foregoing that the estimated "salvage value" of a depreciable asset cannot be redetermined unless there is some "clear and convincing basis" for redetermining the originally estimated "useful life" of the asset in accordance with the rules contained in Section 1.167(a)-1(b). Nothing contained in Section 1.167(a)-1(b) justifies the conclusion that the sale of a depreciable asset in and of itself constitutes a factor to be considered in determining "useful life" of the asset sold. It is true that the regulation purports to set forth merely "some of the factors" to be considered in making such a determination, but it is significant that the sale of an asset is not listed among the factors to be considered. The majority of the Court of Appeals in this case did not discuss or even cite Section 1.167(a)-1(b) or Section 1.167(a)-1(c) of the regulations.

The Tax Court in this case quoted[78] the portion of Section 1.167(a)-1(c) which states that an "asset shall not be depreciated below a reasonable salvage value", and it apparently accepted respondent's argument that, assuming the correctness of respondent's equivalence of "actual sales price" and "salvage value", this provision alone barred petitioner's claimed deduction for depreciation in the year of sale. The assumed equivalence of "actual sale price" and "salvage value" where the sale occurs at mid-life seems such an obvious distortion of the use of words and such a disregard for

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[78] R. 13.

the obvious fact that the value at the time of sale has no relation to the value some time later at the end of the estimated "useful life", that it seems absurd to argue the point. In *S & A Co. v. United States*, 218 F. Supp. 677, 684 (D. Minn. 1963), *aff'd*, 338 F.2d 629, 640 (8th Cir. 1964), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term), both the district court and the Court of Appeals for the Eighth Circuit flatly rejected this assumed equivalence or identity of "actual sale price" and "salvage value".

A similar flaw is present in the Court of Appeal's use[79] of the statement in Section 1.167(b)-0(a) of the regulations that the "reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made." The majority expressed its conclusion that this provision entitled respondent to substitute a "known" sale price for a previously estimated "salvage value".[80] However, this conclusion is valid only if it be assumed that the proceeds of an unanticipated sale of depreciable assets, which sale takes place well before the termination of the "useful life" of those assets in the business, constitute the "salvage value" of such assets. By permitting respondent to assume the point he was required to demonstrate, the Court of Appeals accepted respondent's contention that when an asset is sold the "salvage value" becomes "known" and can be substituted for a "less reliable" previous estimate. Such a substitution would be proper, however, only if the automatic equivalence of sale price and "salvage value" were established.

The Treasury Regulations, therefore, far from establishing the equivalence of "salvage value" and actual sale price when-

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[79]R. 80-81.

[80]R. 81.

ever obtained, all reflect the traditional view of depreciation established by over 40 years of judicial and administrative authority. "Useful life", it will be recalled, is defined as "the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income," and not, as respondent and a majority of the Court of Appeals apparently would have it, as "the period over which the asset may reasonably be expected to be useful to the taxpayer *or the period during which it is actually held by the taxpayer, whichever is less.*" "Salvage value" is defined as "the amount (determined at the time of acquisition) which is estimated will be realizable upon sale of other disposition of an asset when it is no longer useful in the taxpayer's trade or business . . . and is to be retired from service by the taxpayer." It is not defined as "the amount (determined at the time of acquisition) which is estimated will be realizable upon sale . . . of an asset when it is no longer useful . . . *or the amount which is actually realized on sale at any time, whichever is greater.*"

E. The majority of the Court of Appeals ignored the relationship between depreciation, on the one hand, and gain or loss on sale, on the other hand, and the clearly-defined dichotomy between these concepts which is expressed in the tax statute and in the Treasury Regulations and which has been recognized in long-standing judicial precedents and administrative practice.

The accounting authorities discussed above recognize a clearly-defined dichotomy between depreciation of an asset during its period of use in the business and the realization of gain or loss on the subsequent disposition of the asset. The dichotomy, ignored by the majority of the Court of Appeals in this case, is firmly imbedded in the basic statutory provision.

The statutory provisions of the 1954 Code relating to the

determination of gains and losses on property (Sections 1001 and 1002) require downward adjustments in basis for depreciation allowed or allowable (Sections 1011 and 1016(a)(2)).[81] Therefore the gain taxed on a profitable sale is increased to the extent of any depreciation deductions allowed for periods prior to the date of sale.

Section 167 of the Code was intended to require and in fact requires only an accounting for an allocation of depreciation during the period an asset is used in the trade of business, and Section 1231 of the Code was intended to deal with the method of taxing gain or loss (determined in accordance with Sections 1001, 1002, 1011 and 1016(a)(2)) resulting from market fluctuations on the subsequent disposition of the asset. Surely, both respondent and a majority of the Court of Appeals would accept the proposition that (except to the extent Section 1245 or Section 1250 now applies) *all* gains or losses recognizable[82] on the disposition of depreciable assets used in the trade or business for more than six months are accountable for under Section 1231, and nowhere else, including *all* gain resulting from the deduction for depreciation in years prior to the year of sale in amounts in

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[81]Section 1001(a) provides that "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain"; Section 1001(c) provides that "the extent to which gain . . . shall be recognized . . . shall be determined under section 1002"; and section 1002 states that, except to the extent otherwise provided, "the entire amount of the gain . . . determined under section 1001, shall be recognized." Section 1011 provides that the adjusted basis for determining gain or loss shall be the basis "adjusted as provided in section 1016." And section 1016(a)(2) requires that basis be reduced "for exhaustion, wear and tear, obsolescence, amortization, and depletion" previously allowed or allowable with respect to the asset sold. INT. REV. CODE OF 1954, §§ 1001(a), 1001(c), 1002, 1011, and 1016(a)(2).

[82]Congress has not seen fit to provide for the "recognition" of all gains or losses "realized" on the disposition of property. For example, where, as in this case, a corporation adopts a plan of complete liquidation and within 12 months thereafter distributes all of its assets in complete liquidation, the corporation recognizes none of the gains and losses which it realizes on the disposition of property within that 12-month period. INT. REV. CODE OF 1954, §337(a).

excess of the actual "exhaustion, wear . . . tear . . . [and] obsolescence" experienced with respect to the property. The fact that Section 1231 provides a mechanics for adjusting or compensating for such "excessive" depreciation in prior years does not justify using a different method, *viz.*, reduction of the depreciation allowance for the current year, for adjusting and compensating either for year-of-sale depreciation (whether or not excessive) or for factors such as appreciation in market value. On the contrary, the mere existence of Section 1231 with its provisions for adjusting and correcting for excessive depreciation and for reaching appreciation in market value is some evidence that Congress intended that *all* such items be reached by this device. This obviously does not prevent correcting errors in depreciation for the year of sale directly, but as already apparent it basically is the position of taxpayers that the depreciation claimed in this case in the year of sale does not involve any error for the year of sale in that there was "exhaustion, wear . . . tear . . . [or] obsolescence" in such year of sale reflected in the petitioner's acquisition-time estimates for "useful life" and "salvage value" which are not questioned by the respondent.

It is noteworthy that Congress as a matter of policy has allowed taxpayers to deduct depreciation in excess of anticipated "exhaustion, wear . . . tear [and] . . . obsolescence" in numerous situations including first year depreciation of 20 per cent (Section 167(b)(2), (3), and (4)) and accelerated depreciation (Section 179). In such cases it would normally be expected that a sale of such assets at mid-life would result in gain, and yet Congress at no time has legislated to deny any part of the depreciation deduction. Clearly the advantage to the taxpayer so specifically provided by Congress should not be taken away or lessened by administrative action. As we shall see, when Congress finally decided to recapture part or all of the advantage so

granted to taxpayers it did so prospectively, specifically and by adjusting the method of taxing the gain on the sale and not by adjusting the deduction for depreciation.

Clearly, then, under the tax law two separate concepts exist: (1) depreciation under Section 167 during the period the asset is used in the business, and (2) recognition of gain or loss under Section 1231 upon disposition of the asset. As noted, the depreciation allowance provided by Section 167 governs in the determination of the period of time over which the taxpayer is permitted to allocate the cost of an asset in the form of annual depreciation deductions. Section 1.167(a)-10(b) of the Treasury Regulations specifies in express terms that this period of cost allocation "shall begin when the asset is placed in service and shall end when the asset is retired from service." Of course an asset is "retired from service" when it is sold. And in Section 1.167(a)-8(a)(1) of the regulations it is stated that when a depreciable asset is "retired from service" by sale, "recognition of gain or loss will be subject to the provisions of Sections 1002, 1231, and other applicable provisions of law." Obviously, Section 167 is not one of the "other applicable provisions of law" to which the provisions refers. The sharp dichotomy in the tax law is therefore clearly recognized by respondent in his own regulations.

The respondent's unequivocal position as stated in his regulations that the period of cost allocation "shall end when the asset is retired from service" is entirely consistent with his practice for over 40 years of allowing depreciation *to the date of sale* in the year of profitable sale. This practice is amply reflected in long-standing judicial precedents and administrative rulings, practice and acquiescence.

In *Eldorado Coal & Mining Co. v. Mager*, 255 U.S. 522 (1921), this Court sustained an assessment arrived at by "subtracting depreciation and depletion to the date of sale"

of a coal mine in May, 1917, and computing profit on the sale accordingly. Again, in *United States v. Ludey,* 274 U.S. 295 (1927), this Court upheld a determination of gain on the sale of properties computed by deducting depreciation and depletion from March 1, 1913, to the date of their sale in February, 1917 and by making corresponding reductions in the March 1, 1913, basis of the properties to the time of sale. In both of these cases, respondent allowed depreciation on property in the year of its profitable sale and, with the approval of this Court, adjusted the basis of the property for such depreciation in determining the gain on the sale.

The position of the lower courts was just as clear, and they too reflect respondent's long-established practice of allowing depreciation on property in the year of profitable sale. *Beckridge Corp. v. United States,* 129 F.2d 318 (2d Cir. 1942); *Kittredge v. Commissioner,* 88 F.2d 632 (2d Cir. 1937); *Clark Thread Co. v. Commissioner,* 100 F.2d 257 (3d Cir. 1938); *Hall v. United States,* 43 F. Supp. 130 (Ct. Cl.), *cert. denied,* 316 U.S. 664 (1942); *Franklin Lumber & Power Co.,* 18 B.T.A. 1207 (1930), *rev'd on other grounds,* 50 F.2d 1059 (4th Cir. 1931); *Max Eichenberg,* 16 B.T.A. 1368 (1929); *Louis Kalb,* 15 B.T.A. 865 (1929); *Parkersburg & Marietta Sand Co.,* 11 B.T.A. 87 (1928); *Seton Falls Realty Co.,* 6 B.T.A. 883 (1927); *Island Line Shipping Co.,* 4 B.T.A. 1055 (1926); *Capital City Invest. Co.,* 4 B.T.A. 933 (1926); *Cotton Concentration Co.,* 4 B.T.A. 121 (1926); *Walter Frank,* 2 B.T.A. 905 (1925); *Marchetti Roma Cafe Co.,* 2 B.T.A. 529 (1925); *W. W. Carter Co.,* 1 B.T.A. 849 (1925); *Even Realty Co.,* 1 B.T.A. 355 (1925); *Grosvenor Atterbury,* 1 B.T.A. 169 (1924). See also *Thos. Goggan & Bro.,* 45 B.T.A. 218 (1941); *Duncan-Homer Realty Co.,* 6 B.T.A. 730 (1927).

At the urging of respondent, the Board of Tax Appeals expressly held in *Herbert Simons,* 19 B.T.A. 711 (1930), that depreciation had to be computed by the taxpayer in the year

of the profitable sale of depreciable property. In *Wier Long Leaf Lumber Co.,* 9 T.C. 990, 999 (1947), *acq.,* 1948-1 CUM. BULL. 3 (withdrawn), *nonacq.* 1962-1 CUM. BULL. 5, *aff'd and rev'd on other issues,* 173 F.2d 549 (5th Cir. 1949) (the automobile issue), the Tax Court again so held, this time at the insistence of the taxpayer, in the only case up to that point in which respondent had attempted to disallow depreciation in the year of sale. Respondent promptly acquiesced in this adverse decision.[83]

The Court of Appeals for the Eighth Circuit held, in *Forrester Box Co. v. Commissioner,* 123 F.2d 225, 229 (8th Cir. 1941), that a taxpayer who sold machinery and equipment on July 1, 1929, should have "an opportunity to show what the allowable depreciation on the machinery and equipment was from the time it acquired it up to July 1, 1929." And the Third Circuit earlier had held, in *Rieck v. Heiner,* 25 F.2d 453, 454 (3d Cir.), *cert. denied,* 277 U.S. 608 (1928), that "in computing the gain from a sale of property a deduction of depreciation during the period of operation shall be made."

Respondent's long-standing administrative practice was completely consistent with his determinations reflected and approved by the courts in the above cases. In 1920, in O.D. 753, 3 CUM. BULL. 171 (1920), respondent ruled that the sale of plants at a loss did not terminate their "useful life" and did not permit an increased deduction for depreciation for the year of sale. The ruling held that the loss sustained should be deducted as a loss arising from the sale. In 1922, in I.T. 1158, I-1 CUM. BULL. 173 (1922), respondent ruled

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[83]Respondent states in the front of every Internal Revenue Bulletin that decisions so acquiesced in should be "relied upon" as "precedents to be used in the disposition of other cases." Acquiescence also furnishes taxpayers assurance that they can rely upon the disposition of the issue "without the danger of being forced to litigate the same question in their own cases." *Stockstrom v. Commissioner,* 190 F.2d 283, 284 (D.C. Cir. 1951).

that depreciation on assets disposed of within any taxable year should be computed for the period from the beginning of the year of sale to the date of sale. Later in that year, in I.T. 1494, I-2 CUM. BULL. 19, 20-21 (1922), respondent approved depreciation of property to $40,000 in the year of sale for $47,000, stating that "The real economic result of every sale of depreciable property is obtained by comparing the sale price with the cost, depreciated to the date of sale." In 1924 (A.R.R. 6930, III-1 CUM. BULL. 45 (1924)) and again in 1927 (G.C.M. 1597, VI-1 CUM. BULL. 71 (1927)), respondent approved depreciation in the year of profitable sale. And in 1928, he published in VII-1 CUM. BULL. 200 (1928) the decision of the Third Circuit in *Rieck v. Heiner, supra.*

In 1948, as pointed out above, respondent published in 1948-1 CUM. BULL. 3 his acquiescence in the decision of the Tax Court in *Wier Long Leaf Lumber Co., supra.*

In 1951, in T.D. 5851, 1951-2 CUM. BULL. 63, respondent amended the income tax regulations to conform them to Section 117(g) of the Internal Revenue Code of 1939 which Congress added to the 1939 Code in 1950. T.D. 5851 incorporated in respondent's regulations (see 1951-2 CUM. BULL. at 73) an example contained in the Conference Report on the Revenue Act of 1950 specifically illustrating the allowance of $500 of depreciation in the year of sale of a facility at a profit of $500. Subsequently, in 1957 respondent issued T.D. 6253 1957-2 CUM. BULL. 547, 562-63, which updated the example as part of Section 1.1238-1 of respondent's regulations under the 1954 Code, and the example still was part of the regulations until June 1, 1965, when respondent amended the example in order to eliminate year-of-sale depreciation. T.D. 6825, 1965 Int. Rev. Bull. No. 26, at 6, 30 Fed. Reg. 7281 (1965).

Respondent cannot argue (as erroneously stated by the Eighth Circuit in *United States v. S & A Co.*, 338 F.2d 629,

633 (8th Cir. 1964), *affirming* 218 F. Supp. 677 (D. Minn. 1963), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term)) that prior to 1942 the deduction of depreciation in the year of sale was immaterial because capital gains on the sale of depreciable property were taxed in the same manner as other income. From 1921 to 1934 all taxpayers other than corporate taxpayers were permitted to elect a maximum alternative tax on gain from the sale of capital assets including depreciable property held over two years[84] similar to that now provided by the Code.[85] From 1934 to 1938 those taxpayers were taxed on a varying percentage of such gain, depending on the period held.[86] During this period, corporate taxpayers under some circumstances also might have derived tax benefit from year of sale depreciation. See Vol. 3, 1935 Stand. Fed. Tax Serv. ¶5185, at 6630-31 (Feb. 27, 1935). From 1938 to 1942, no taxpayers were entitled to capital gain treatment on the sales of depreciable property.[87] However, this preferential treatment was reinstated for all taxpayers in 1942.[88] Thus, except for the period 1938 to 1942, it has since 1921 been of potential tax benefit to taxpayers to deduct depreciation in the year of sale and pay a tax on the increased gain which resulted by reason of the dichotomy in the income tax laws which has always existed. Throughout this period, respondent apparently never asserted that year-of-sale depreciation was not

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[84]See Rev. Act of 1921, §206(a)(6), (b); Rev. Acts of 1924 and 1926, §208 (a)(8), (b), (c); Rev. Acts of 1928 and 1932, §101(a), (b), (c)(8).

[85]Int. Rev. Code of 1954, §1201.

[86]See Rev. Acts of 1934 and 1936, §117(a), (b). The percentage of gain recognized varied from 100 percent if the property had been held for less than one year to only 30 percent if the property had been held for over 10 years.

[87]Rev. Act of 1938, §117(a)(1) expressly excluded depreciable property from the definition of "capital asset".

[88]See note 89 *infra* and accompanying text.

deductible (*cf. Duncan-Homer Realty Co.,* 6 B.T.A. 730 (1927)), issued rulings holding that year-of-sale depreciation must be deducted, was sustained by the courts in numerous court cases in reducing basis for depreciation allowable prior to the date of sale, including year-of-sale depreciation, and in the only reported case where the issue as to year-of-sale depreciation was separately raised took the position (contrary to the position taken by the taxpayer because of a peculiar interplay in the alternative tax computations) that year of sale depreciation *must* be deducted. In this position respondent was sustained by the Board of Tax Appeals. *Herbert Simons,* 19 B.T.A. 711 (1930).

F. The lower courts in this case ignored clear indicia of Congressional intent as reflected for more than 20 years.

Considerable evidence of Congressional knowledge of the subject at hand is found in its legislative actions over the past 22 years. In 1942, Congress amended the Internal Revenue Code of 1939 to extend to all taxpayers who sold at a profit depreciable assets used in a trade or business and held for more than six months the favorable tax treatment accorded to long-term capital gain.[89] After 1942 (and with no exceptions until 1951) Congress permitted taxpayers to deduct depreciation in excess of "exhaustion, wear . . . tear . . . [and] obsolescence" in many situations including so-called accelerated depreciation and emergency facility depreciation. For a number of years Congress did not make any provision to limit such depreciation deductions when the asset was sold at mid-life, nor did it make any special adjustments as to the method of taxing the gain on sale even though such gain necessarily resulted even in the absence of any ap-

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[89]Int. Rev. Code of 1939, §117(j), added by Rev. Act of 1942, §151(b) (now Int. Rev. Code of 1954, §1231).

preciation in value. In 1947, Congress received a report from the Treasury Department warning against the revenue losses resulting under this provision from sale of assets subject to accelerated depreciation and recommending that, to the extent of the excess of accelerated over normal depreciation, such gains should be treated as ordinary income.[90] However, Congress did not act on this recommendation.

In developing the Revenue Act of 1950, Congress considered the possibility of taxing gains from sales of depreciable assets as ordinary income, but rejected the idea because it presented serious difficulties.[91] However, Congress did enact in that Revenue Act a much more limited restriction on the availability of capital gain treatment for depreciable assets. In connection with the authorization of 60-month amortization of emergency facilities certified as necessary in the interest of national defense,[92] Congress provided that gain from the sale of such facilities should, to the extent that deductions for such amortization exceeded the deduction otherwise allowable for depreciation, be taxed as ordinary income

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[90] *Hearings Before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess. on Revenue Revisions 1947-48, Part 5,* at 3756 (Report of Business Tax Section, Division of Tax Research, Treasury Department).

[91] At the recommendation of the Treasury Department, the House Ways and Means Committee had proposed, in section 209(b) of the House bill (H.R. 8920, 81st Cong., 2d Sess.), that Section 117(j) of the 1939 Code be amended to treat losses on sales of depreciable assets as capital, rather than as ordinary, losses. H.R. Rep. No. 2319, 81st Cong., 2d Sess. 45 (1950). The Senate Finance Committee rejected this change. (S. Rep. No. 2375, 81st Cong., 2d Sess. 51-52 (1950)), and its views prevailed. In the discussion on the floor of the Senate, Senator Milliken, in explaining the Committee's action, stated that "the reverse procedure which involves conforming the treatment of gains to losses and taxing the gains on the sale of section 117(j) assets as ordinary income also presents serious difficulties" and, hence, the "Committee decided that it was best not to change section 117(j) at this time." 96 Cong. Rec. 14057 (1950).

[92] Int. Rev. Code of 1939, §124A, added by Rev. Act of 1950, §216(a) (now Int. Rev. Code of 1954, §168).

instead of capital gain.[93] The Conference Report on this provision contained an example illustrating its operation as follows:[94] an emergency facility acquired on December 31, 1950, for $10,000 was sold on December 31, 1952, for $9,500. Amortization of $4,000 had brought its adjusted basis down to $6,000 *at the date of sale,* while regular depreciation (at $500 a year) *to the date of sale* would have brought the adjusted basis down only to $9,000. Under the amendment, the Committee of Conference stated in its report, $3,000 of the gain would be treated as ordinary income and $500 as long-term capital gain. Obviously, under the Congressional view, had ordinary depreciation been taken, a $500 depreciation deduction was allowable for the year of sale even though the sale price exceeded basis. The same view was until June 1, 1965, reflected in the examples in the Treasury Regulations under this statutory provision.[95]

In considering the Revenue Act of 1951, Congress was again concerned with the availability of capital gain treatment on sales of depreciable property. The Internal Revenue Service had called the attention of Congress to the growing practice of sales of depreciated assets between related taxpayers for the purpose of obtaining a combination of capital gain treatment on the sale and an increased basis for future depreciation purposes.[96] Congress forestalled the continued use of this device by requiring the gain to be treated as ordinary income in the case of sales between an individual and his controlled corporation or between closely related individ-

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[93]Int. Rev. Code of 1939, §117(g)(3), added by Rev. Act of 1950, §216(c) (now INT. REV. CODE OF 1954, §1238).

[94]H.R. REP. No. 3124, 81st Cong., 2d Sess. 29 (1950).

[95]Treas. Reg. §1.1238-1, Examples (1) and (2), amended by T.D. 6825, 1965 Int. Rev. Bull. No. 26, at 6, 30 Fed. Reg. 7281 (1965).

[96]H.R. REP. No. 586, 82d Cong., 1st Sess. 26 (1951).

uals,[97] but again left capital gain treatment otherwise available to sales of depreciable assets and made no effort to adjust the depreciation deduction in the year of sale even though excessive depreciation may have been allowed to the taxpayer.

During the development of the Internal Revenue Code of 1954, Congress again received the recommendation that gains from sales of depreciable assets should be taxed as ordinary income,[98] and again did not adopt it. Congress authorized new rapid depreciation methods in the Internal Revenue Code of 1954,[99] which would normally assume the realization of gain on sale of the asset at mid-life, but reenacted without substantive change the provision authorizing capital gain treatment for profits on sales of depreciable assets.[100]

The President's budget message to the Congress on January 18, 1960, again proposed legislation limiting capital gain treatment on the sale of depreciable business property. Noting that "administration of the depreciation provisions is being hampered by the attempts of some taxpayers to claim excessive depreciation before disposing of their property," the President recommended "that consideration be given to a change in the law which would treat such gain as ordinary income to the extent of the depreciation previously taken on

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[97]Int. Rev. Code of 1939, §117(o), added by Rev. Act of 1951, §328(a) (now Int. Rev. Code of 1954, §1239).

[98]*Hearings Before the Committee on Finance, United States Senate, 83d Cong., 2d Sess. on H.R. 8300, Part 3,* at 1324 (Recommendation No. 180 of American Institute of Accountants).

[99]Int. Rev. Code of 1954, §§ 167(b)(2), (3), and (4).

[100]Int. Rev. Code of 1954, §1231. "This section is derived from section 117 (j) of the present law. There is no substantive change intended. . . ." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A275 (1954). In the floor discussion, Representative Curtis called the attention of the House to the fact that the combination of the new depreciation methods and the capital gain provisions of section 1231 might well "accentuate" already existing capital gain advantages. 100 Cong. Rec. 3678 (1954).

the property."[101] The Secretary of the Treasury, by identical letters dated February 12, 1960, to the Vice President and to the Speaker of the House of Representatives, transmitted to Congress proposed legislation to implement the President's recommendation.[102] In these letters the Secretary of the Treasury said that enactment of the "proposed legislation, by eliminating the opportunity which now exists of converting ordinary income into capital gains, would contribute to the sound administration of the depreciation laws." The President renewed his request in a letter to Congress dated April 20, 1961, in which he made the cogent observation that "the statutory rate of depreciation may not coincide with the actual decline in the value of an asset."[103]

Congress finally adopted a portion of the President's recommendation by providing, in a 1962 amendment to the Internal Revenue Code of 1954, that in the case of dispositions of depreciable personal property in 1963 and later years, gain to the extent of depreciation deductions taken in 1962 and later years would be ordinary income, and the remainder would be capital gain.[104] The Committee Reports on this enactment could not more clearly state the Congressional view that depreciation deductions may exceed the decline in value of the property and that, but for the new provision, this excess is recapturable by the taxpayer at capital gain rates.[105]

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[101] THE BUDGET OF THE UNITED STATES GOVERNMENT FOR THE FISCAL YEAR ENDING JUNE 30, 1961, at M11.

[102] Treasury Department Release A-761, dated February 15, 1960.

[103] The letter is reprinted in *Hearings Before the Committee on Ways and Means, House of Representatives, on the President's 1961 Tax Recommendations* (H.R. Doc. No. 140, 87th Cong., 1st Sess.), vol. 1, at 13. The testimony of the Secretary of the Treasury on this recommendation is recorded at pages 44-45 of those *Hearings*.

[104] INT. REV. CODE OF 1954, §1245, added by Rev. Act of 1962, §13(a).

[105] H.R. REP. No. 1447, 87th Cong., 2d Sess. 66-67 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 95 (1962).

In 1963, the Administration renewed its request that similar treatment be accorded to gain on the disposition of depreciable real property.[106] And in a 1964 amendment to the Internal Revenue Code of 1954,[107] Congress provided (with certain modifications) that gain from dispositions in 1964 and later years of depreciable real property (but limited generally to real property held for less than 10 years) should be treated as ordinary income to the extent that the gain is equal to or less than post-1963 depreciation, and as capital gain to the extent that the gain exceeds such depreciation.[108]

In neither 1962 nor 1964 did Congress make any attack on the depreciation deduction as such. Thus, for more than 20 years Congress has been aware that accelerated depreciation in excess of "exhaustion, wear . . . tear . . . [and] obsolescence" was being deducted and that depreciation was being allowed in the year of profitable sale, and until 1962 it made no attempt to limit such deductions, and then the problem was approached entirely through a change in the nature of the gain realized and *not* through an adjustment of the depreciable deduction. The fact that in the 1962 amendment pertaining to dispositions of depreciable personal property it limited the application of the amendment to post-1961 depreciation deductions allowed on the prop-

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[106] *Statement of Secretary of the Treasury Before the Committee on Ways and Means, House of Representatives, on the President's Special Message on Tax Reduction and Reform, on February 6, 1963*, at 25.

[107] Int. Rev. Code of 1954, §1250, added by Rev. Act of 1964, §231(a).

[108] The portion of the gain taxable as ordinary income is a percentage of the excess of post-1963 depreciation deductions over straight-line depreciation. The percentage is 100 percent for the first 20 full months the property is held and decreases 1 percent per month thereafter until the gain is 100 percent capital gain at the end of 10 years. INT. REV. CODE OF 1954, §§ 1250(a)(1), (2) and 1250(b)(1). The Committee Reports with respect to this legislation for the first time indicate an awareness by Congress of the controversy exemplified by this litigation, and Congress in effect took a neutral attitude. See H.R. REP. No. 749, 88th Cong., 1st Sess. 103 (1964); S. REP. No. 830, 88th Cong., 2d Sess. 133 (1964).

erty, and the added fact that in the 1964 amendment pertaining to dispositions of depreciable real property Congress limited the application of the amendment to post-1963 depreciation deductions allowed on property held for less than 10 years, suggest Congressional cognizance of the interrelationship of the depreciation and capital gain provisions and its awareness of depreciation patterns which can fairly be changed only prospectively.

The lack of correlation between market value and depreciated cost was specifically brought before Congress on three occasions prior to the adoption of the 1954 Code, and in 1950,[109] Congress, in dealing with the general problem, specifically recognized the deductibility of depreciation in the year of sale. This recognition was found in respondent's Treasury Regulations until June 1, 1965, was otherwise consistent with respondent's practice until June 7, 1962 (the day before the trial of this case) when respondent announced his new position that he no longer would allow depreciation in the year of profitable sale of an asset,[110] and is reflected in a long series of judicial decisions, including *Wier Long Leaf Lumber Co.* in which respondent had acquiesced for 14 years until June 25, 1962 (one week after the taxpayer had instituted suit in the *S & A Co.* case) when such acquiescence was withdrawn.[111] Under these circumstances, when Congress reenacted the depreciation provision of the income tax law at the time it adopted the 1954 Code, it in effect approved the interpretation of those provisions as found in the existing judicial interpretation and administrative regulations and rulings issued by respondent, which thereby acquired the

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[109]See note 94 *supra* and accompanying text.

[110]Treasury Information Release 374, dated June 7, 1962, reissued as Rev. Rul. 62-92, 1962-1 Cum. Bull. 29.

[111]1962-1 Cum. Bull. 5.

force of law. *Cammarano v. United States,* 358 U.S. 498, 509-12 (1959); *Hecht v. Malley,* 265 U.S. 144 (1924); 1 SUTHERLAND, STATUTORY CONSTRUCTION ¶1935 (3d Ed. 1943). See also *Commissioner v. Brown,* ---- U.S. ----, CCH 1965 Stand. Fed. Tax Rep. (65 U.S. Tax Cas.) ¶9375, at 95,343 (Apr. 27, 1965). This is particularly true in the light of the *specific,* as opposed to the inferred, consideration given by Congress to the problem. See *Commissioner v. P. G. Lake, Inc.,* 356 U.S. 260 (1958); *United States v. Calamaro,* 354 U.S. 351 (1957); *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426 (1955).

It could not be clearer that respondent, failing since 1942 to persuade Congress to change the tax laws in order to correct so-called "abuses" resulting from favored capital gains treatment accorded taxpayers on the disposition of depreciable assets, took it upon himself to change the law administratively, in utter disregard of all precedent and principle.

G. The theory adopted by the lower courts in this case has been thoroughly discredited by the overwhelming weight of contemporary court decisions.

The most comprehensive judicial discussion and analysis of the application to the issue involved in this case of the well-settled principles discussed in this brief are found in the opinion of the Court of Appeals for the Eighth Circuit in *S & A Co. v. United States,* 218 F. Supp. 677 (D. Minn. 1963), *aff'd,* 338 F.2d 629 (8th Cir. 1964), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term). In the *S & A Co.* case, the facts were undisputed: the taxpayer used a taxable year ending August 31, and on April 1, 1956, sold all of its operating assets as part of the sale of its going business, which was the manufacture and sale of outboard motors. The purchaser acquired the taxpayer's business for the purpose of conducting the same business at

the same location and with substantially the same employees, and it in fact did so. Included in the assets sold were depreciable assets, and the portion of the total sale price allocated to such assets not only exceeded the undepreciated basis of the assets as of September 1, 1955, but also exceeded the original cost of such assets as well. On taxpayer's tax return for its taxable year ending August 31, 1956, the taxpayer claimed depreciation of $125,481.77 with respect to the depreciable assets for the period September 1, 1955, to April 1, 1956. The taxpayer's computation of this claimed deduction for depreciation was based upon the rates of depreciation claimed by the tax year and allowed by respondent with respect to such assets on taxpayer's prior returns. There was no dispute that the claimed deduction for depreciation of $125,481.77 was a "reasonable allowance" for depreciation for the period September 1, 1955, to April 1, 1956, with respect to the assets sold on the latter date, unless the sale in and of itself created a reason for changing the depreciation allowance.

Respondent disallowed the claimed depreciation for the year of sale only, but did not challenge the taxpayer's estimates of "useful life" or "salvage value", nor did he challenge depreciation claimed in prior open years. The district court found the following facts (in addition to those summarized above): at the times when the taxpayer acquired the depreciable assets which it sold on April 1, 1956, and at all times prior to the sale, the taxpayer intended to use such assets in the business for the full duration of their economic or physical life; at the times when the taxpayer acquired the depreciable assets in question, it estimated the period of usefulness of such assets in the business to be the full duration of their economic or physical life; at the time when the taxpayer acquired such assets and at all times prior to the sale, taxpayer's expectation that such assets would be useful

in the business for the full duration of their economic or physical life was reasonable and wholly consistent with its experience with these and similar assets used in its business; from the times when the taxpayer acquired such assets until the time of sale, the experience of the taxpayer with respect to these and similar assets was wholly consistent with and reflected taxpayer's expectation and intention of using such assets in the business for the full duration of their economic or physical life; at no time prior to the sale of such assets, did the taxpayer have a predetermined plan to sell or otherwise dispose of such assets prior to the expiration of the full duration of their economic or physical life; the "useful life" in the business of the depreciable assets did not end or change on or before August 31, 1956; and as of April 1, 1956, the depreciable assets sold on that date had an average estimated remaining "useful life" in the business of approximately 10 years.

On the basis of these findings, the district court distinguished this Court's decisions in *Massey* and *Hertz* and the Sixth Circuit's decision in *Cohn* and concluded that the amount of the total sale price realized by the taxpayer on the sale of its assets on April 1, 1956, which was allocated by the taxpayer to the depreciable assets sold on that date, merely reflected the market value of such depreciable assets at a particular point of time prior to the end of the "useful life" of such assets in the business; that the excess of such portion of the total sale price allocated to such depreciable assets over the undepreciated cost of such assets on September 1, 1955, constituted mere appreciation in value; and that the amount of the total sale price allocated by the taxpayer to such depreciable assets did not determine or reflect the "salvage value" of such assets. Accordingly, the district court upheld the taxpayer's claimed deduction for year-of-

sale depreciation. The Government appealed this adverse decision to the Eighth Circuit.

The Eighth Circuit affirmed the decision of the district court. The Court exhaustively reviewed the fundamental concepts of depreciation accounting for income tax purposes, the long-standing judicial precedents, administrative rulings, practice, and acquiescence, repeated statutory reenactments, and the pertinent provisions of the tax statute and the Treasury Regulations. Applying the principles established by these authorities, the Eighth Circuit turned to the facts before it and made the following observations:[112]

> 1. The facts here possess impressive strength. The taxpayer's sale of its outboard motor assets was a sale of a going business. It acquired those assets and continued to hold them with, at all times, the intent to keep and utilize them in its business until the end of their economic life. It did not intend to dispose of them in the midst of that life and it had established no practice of early disposal, as was the situation in both Massey and Hertz. No challenge is made as to the correctness of the acquisition estimates of useful life and salvage value at the end of that life. The Commissioner accepted these estimates for all prior tax years and would have accepted them for fiscal 1956 had the sale not taken place in that year.
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> 6. With no dispute here as to either cost or useful life, the case hinges on salvage value. But this is to be determined, not at the time of the asset's retirement, but at the time of acquisition. . . .
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> 7. There is no absolute identity of salvage value with sales price. The one is not necessarily equivalent to the other. Neither the statute nor the regulations equate them or make an exception out of the sale year. The emphasis, as has been noted, is, instead, on the estimate of salvage value, on such estimate at acquisition, on rede-

[112] 338 F.2d at 639-43.

termination as the exception, on the distinct possibility of gain or loss on disposition, and on divorcement of salvage value from price level fluctuations.

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10. On the facts before us those provisions of Reg. §1.167(b)-(0)(a) which deny depreciation beyond cost less salvage value and which determine the reasonableness of a claim for depreciation upon "conditions known to exist at the end of the period" do not defeat this taxpayer's claim for depreciation. Of course, a favorable sale price might, in some instances, be a factor indicative of acquisition-estimate error. But this is not necessarily so and, it seems to us, is distinctly not so where, as in this case, there has been and still is no challenge as to cost and as to the useful life and salvage value acquisition estimates. The propriety of all three factors is accepted. The lack of challenge to the taxpayer's claimed and parallel depreciation deductions in prior tax years which were still open for audit adjustment is a concession to their propriety.

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11. This is not a situation where the assets are sold at or near the very end of useful life in the taxpayer's hands. . . .

12. We have here, instead, an unanticipated sale in midlife. This record contains nothing which discloses any change in the economic life of the assets. The sale itself did not change this.

13. There is a logical inconsistency in the government's attack on year-of-sale depreciation and its allowance of the depreciation in preceding years still open for adjustment when the sale facts became known to the government. . . .

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15. The government's position seems to emphasize hindsight and to abandon the concept that depreciation rests on prospective estimates which, to be sure, must be reasonable. It would, to use Judge Blumenfeld's words in Motorlease, p. 363 of 215 F. Supp., "set up an automatic hindsight re-evaluation which becomes a self-

executing redetermination of salvage value triggered by the sale of depreciable assets".

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19. We have deep respect for the conclusions reached by the Second Circuit majorities in Fribourg and Motorlease. But we cannot escape the feeling that the results in those cases underestimate both the law's dichotomy of approach to depreciation and to capital gain and, as well, the fact distinction, . . . so inherent in Cohn, between an intended sale of depreciable assets at or near the end of useful life and an unanticipated sale in mid-life. . . .

On the basis of the foregoing, the Eighth Circuit concluded:[113]

After earnest consideration of all the arguments which have been advanced upon us by the contending parties, we reach the conclusion that, on the facts here presented —unanticipated and noncustomary sale in mid-life of a depreciable asset; acceptance of the correctness and reasonableness of the taxpayer's acquisition estimates of useful life and salvage value; actual approval of depreciation based on these estimated in prior years, some of which still remained open; and the inescapable inference that the claimed depreciation would have been allowed for the sale year had the sale not taken place— the taxpayer has sustained its burden of proof and is entitled to the deduction. . . .

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[113] *Id.* at 639.

In recent years, in addition to the Eighth Circuit, the Tax Court[114] (except for a brief period of departure[115]), and the federal district courts[116] (with one exception[117]), have uniformly applied the well-established principles of depreciation accounting developed and followed in a long line of ju-

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[114]Engineers Ltd. Pipeline Co., 44 T.C. ___ No. 25, CCH Tax Ct. Rep., Dec. 27,411 (May 28, 1965); L. M. Lockhart, 43 T.C. 776 (1965), on appeal to Ninth Circuit; Bell Lines, Inc., 43 T.C. 358 (1964); Holder Driv-Ur-Self, Inc., 43 T.C. 202 (1964), *nonacq.*, 1965 Int. Rev. Bull. No. 30, at 6; Harry Trotz, 43 T.C. 127 (1964), on appeal to Tenth Circuit; Smith Leasing Co., Inc., 43 T.C. 37 (1964), on appeal to Fifth Circuit; Macabe Co., Inc., 42 T.C. 1105 (1964), on appeal to Ninth Circuit; Herschel M. Hays, CCH Tax Ct. Mem. 1965-213, 24 CCH Tax Ct. Mem. 1103 (Aug. 9, 1965); Specialty Paper & Board Co., CCH Tax Ct. Mem. 1965-208, 24 CCH Tax Ct. Mem. 1085 (July 28, 1965); W. Lawrence Oliver, CCH Tax Ct. Mem. 1965-83, 24 CCH Tax Ct. Mem. 438 (Apr. 7, 1965); The Covered Wagon, Inc., CCH Tax Ct. Mem. 1965-79, 24 CCH Tax Ct. Mem. 427 (Apr. 5, 1965); Harry Friend, CCH Tax Ct. Mem. 1965-35, 24 CCH Tax Ct. Mem. 192 (Feb. 23, 1965), on appeal to Fourth Circuit; Melvon C. Miller, 23 CCH Tax Ct. Mem. 1866 (1964); Moses Lake Homes, Inc., 23 CCH Tax Ct. Mem. 1756 (1964); Palmaneda Adams, 23 CCH Tax Ct. Mem. 1743 (1964), on appeal to Sixth Circuit.

[115]Randolph D. Rouse, 39 T.C. 70 (1962), *overruled*, Macabe Co., Inc., 42 T.C. 1105 (1964); Contra Costa Trucking Co., 22 CCH Tax Ct. Mem. 1018 (1963); Fribourg Navigation Co., Inc., 21 CCH Tax Ct. Mem. 1533 (1962), *aff'd*, 335 F.2d 15 (2d Cir. 1964), *cert. granted*, ___ U.S. ___ (No. 679, 1964 Term; renumbered No. 23, 1965 Term). Inasmuch as the Tax Court, in deciding *Contra Costa Trucking Co.* and this case, considered its prior decision in *Rouse* as dispositive of the issue before it, it would appear that the necessary effect of the Tax Court's overruling of its decision in *Rouse* would be implicit repudiation of its prior decisions in *Contra Costa Trucking Co.* and this case.

[116]Mountain States Mixed Feed Co. v. United States, ___ F. Supp. ___, CCH 1965 Stand. Fed. Tax Rep. (65-2 U.S. Tax Cas.) ¶ 9551 (D. Colo. May 26, 1965); R. A. Heintz Constr. Co. v. United States, ___ F. Supp. ___, CCH Stand. Fed. Tax Rep. (65-2 U.S. Tax Cas.) ¶ 9455 (D. Ore. Mar. 25, 1965); Occidental Loan Co. v. United States, 235 F. Supp. 519 (S.D. Calif. 1964), on appeal to Ninth Circuit; Wyoming Builders, Inc. v. United States, 227 F. Supp. 534 (D. Wyo. 1964), on appeal to Tenth Circuit; S & A Co. v. United States, 218 F. Supp. 677 (D. Minn. 1963), *aff'd*, 338 F.2d 629 (8th Cir. 1964), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term); The Motorlease Corp. v. United States, 215 F. Supp. 356 (D. Conn. 1963), *rev'd*, 334 F.2d 617 (2d Cir. 1964), *petition for cert. filed* (No. 685, 1964 Term; renumbered No. 24, 1965 Term); Kimball Gas Prods. Co. v. United States, ___ F. Supp. ___, CCH 1963 Stand. Fed. Tax Rep. (63-2 U.S. Tax Cas.) ¶ 9507 (W.D. Tex. Nov. 3, 1962), on appeal to Fifth Circuit.

[117]Killebrew v. United States, 234 F. Supp. 481 (D. Tenn. 1964), on appeal to Sixth Circuit.

dicial, administrative, and accounting precedents and recognized in repeated statutory reenactment, and have flatly rejected respondent's new theory as a radical departure from these precedents. The Court of Appeals for the Second Circuit now stands alone (except for one district court opinion) in its acceptance of respondent's new theory, a theory which is no longer accepted even by the Tax Court whose decision the Court of Appeals affirmed in this case.[118]

CONCLUSION

In the light of the principles discussed in this brief which are embodied in the basic statutory provision and which have been recognized by the courts, respondent, and well-established accounting practice, it becomes apparent that the question as to the allowability of a deduction for depreciation in the year of profitable sale turns on evidentiary matters. In order to sustain his claimed deduction for depreciation in the year of profitable sale, or in any other year for that matter, the taxpayer has the burden of proving that his acquisition-time estimates of "useful life" and "salvage value" were reasonable. If the taxpayer does not carry this burden of proof, the trier of fact would be justified in concluding that the taxpayer's claimed deductions for depreciation in all years, *not* merely the year of sale, were excessive. On the other hand, once the taxpayer has carried his burden of proof on the reasonableness of his acquisition-time estimates, it follows that the trier of fact would be justified in concluding only that, as a matter of law, the claimed deductions for depreciation in *all* years, including the year of sale, were reasonable and therefore allowable. Obviously, when, as in this case, re-

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[118]See note 115 *supra*. Moreover, in a fully reviewed opinion in Macabe Co., Inc., 42 T.C. 1105, 1110 (1964), the Tax Court expressed its disagreement "with the rationale relied upon by a majority of the panel [of the Court of Appeals for the Second Circuit] which decided" *Fribourg*.

spondent has conceded not only that the acquisition-time estimates of "useful life" and "salvage value" were reasonable, but also that the claimed deduction for depreciation in the year of sale is reasonable and allowable but for the sole fact of the unanticipated sale, it follows that the respondent has conceded himself out of court.

Against respondent's "prior long-standing and consistent interpretation"—as repeatedly reflected and approved in decisions of this Court and many lower courts—his "more recent *ad hoc* contention as to how the statute should be interpreted cannot stand." *United States v. Leslie Salt Co.*, 350 U.S. 383, 396 (1956). A principle so thoroughly established by the vast body of precedents and by repeated statutory reenactment should not be overturned at this late date except by legislative revision. As a majority of this Court recently has observed, it would be "wise to leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications." *Commissioner v. Brown*, ___ U.S. ___, CCH 1965 Stand. Fed. Tax Rep. (65 U.S. Tax Cas.) ¶9375, at 95,343 (Apr. 27, 1965), quoting *American Automobile Ass'n v. United States*, 367 U.S. 687, 697 (1961).

For the foregoing reasons, the decision of the majority of the Court of Appeals in this case should be reversed by this Court.

Respectfully submitted,

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APPENDIX

Treasury Regulations*

§1.167(a)-1 Depreciation In General. — (a) *Reasonable allowance.* — Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and §1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions,

*As in effect during the calendar years 1956 and 1957.

and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and §1.167(d)-1.

(c) *Salvage.*—Salvage value is the amount (*determined at the time of acquisition*) *which is estimated will be* realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. *Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life.* Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value

may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, §1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve. [Italics supplied.]

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§1.167(a)-8. Retirements. (a) *Gains and losses on retirements.* For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful

life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

* * *

§1.167(a)-9 Obsolescence. — The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of an asset is suddenly terminated, see section 165 and the regulations thereunder. If the estimated useful life and the depre-

ciation rates have been the subject of a previous agreement, see section 167(d) and §1.167(d)-1.

§1.167(a)-10 When Depreciation Deduction Is Allowable.—(a) A taxpayer should deduct the proper depreciable allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. . . .